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SUBJECT: South China Financiers Prepare for China's First Real Financial Crisis in Thirty Years

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¶1. (SBU) Summary: The withdrawal of inter-bank credit lines to foreign banks following Lehman's collapse was largely due to bankers' concerns about increased counter party risks, according to south China bankers. They told Financial Minister Counselor Loevinger that regulators did not explicitly instruct Chinese banks to reduce exposure, but implicitly signaled concern by asking for daily reports of exposure. Financiers are preparing for an extended economic downturn, described by one contact as the first "real financial crisis" since China adopted its reform and opening policy 30 years ago. Given excess production capacity among many borrowers and the worsening outlook for borrowers' sales and profitability, bankers expect lenders to be increasingly reluctant to lend and borrowers to be increasingly reluctant to incur additional debt. The recent lifting of credit controls and reduction in reserve requirements and interest rates won't be effective in overcoming this reluctance. They expect non-performing assets to rise (particularly to small and medium-sized private exporters) and bank profits to fall next year. While they expect local officials to pressure banks to support enterprises in isolated cases, they do not anticipate systemic moral suasion to prop up unviable enterprises. End summary.

Stability is Key

¶2. (SBU) In a recent meeting with Financial Minister Counselor David Loevinger, China Merchant's Bank (CMB) Executive Vice President Zhang Guanghua said inter-bank lending in recent weeks had "mostly" returned to normal for the first time since they were suspended immediately after Lehman's collapse. (Comment: Some foreign banks report that they still have difficult getting RMB credit from Chinese banks.) He said that the withdrawal of inter-bank credit lines to foreign banks had been largely due to bankers' concerns about increased counter party risks. Regulators did not instruct Chinese banks to reduce exposure, but instead signaled concern by asking for daily reports on such exposure, according to Zhang.

¶3. (SBU) Zhang said his bank had suffered direct Lehman bond losses of approximately USD 70 million and losses of 20 percent on its approximately USD 1 billion in holdings of fixed income and equity of U.S. financial institutions. However, he emphasized that CMB was less exposed to U.S. assets than China's biggest banks. He praised U.S. government efforts to stabilize financial markets.

¶4. (SBU) Before Lehman's collapse, Zhang had expected the financial

crisis to be over in one to two years, but he now expects a longer period of weak growth. He said the "panic" in financial markets appeared less threatening now, however, his bank was preparing for difficult conditions in the near and medium term, citing the slowdown in China's export growth and real economy. China's top banks (China Merchant's is the sixth largest) have set aside a total of RMB 15 billion (approximately USD 2.2 billion) for possible write-downs, according to Zhang.

¶5. (SBU) Guangdong Development Bank (GDB) President Michael Zink described a recent meeting he had with local officials in Guangdong's coastal city of Zhanjiang where Communist Party leaders, sugar factory owners and representatives of local sugar cane farmers pressed GDB to provide interim financing to pay for harvesting and processing of the current crop. They pressed him arguing that such financing would prevent disgruntled sugar cane farmers from "burning down government offices." Zink speculated that few such meetings end as this one did because, in this case, the bank was represented by a non-Party member. GDB agreed to provide financing only after the government identified buyers for this year's crop, but without committing to incur losses to support the area's largest sugar company or sacrificing the bank's fiduciary duty to shareholders.

Predictions of an Extended Economic Downturn

¶6. (SBU) Vice CEO of Shenzhen Stock Exchange (SSE) Dai Wenhua predicted an extended downturn, amplified by slowing export growth and declining real estate values in south China. Dai said this was the first "real financial crisis" to seriously impact China since the country adopted its reform and opening policies 30 years ago. New initial public offerings ceased in October as central government regulators stopped authorizing new listings, and the

long-anticipated launch of a new SSE board for small companies now appears indefinitely postponed until market conditions improve (ref A). In addition, Dai said Chinese qualified domestic institutional investors (QDII - those who bought foreign securities via licensed mainland dealers) had seen their investments drop by an average of 40 percent, spurring many calls from upset investors, and a possible area of concern for government authorities concerned about broader social stability. Dai also expects a slowdown in the development of Chinese derivative markets.

Inherent Contradictions in PRC Responses

¶7. (SBU) Shenzhen Development Bank (SDB) President Frank Newman said south China's current economic difficulties, and the options available to prevent greater damage, were hampered by structural weaknesses in the domestic financial system. Weak and over-regulated equity markets, as well as under-developed bond markets, mean that bank loans are the only real source of financing for struggling companies, especially small and medium sized enterprises (SMEs) (ref B). Although the government has eliminated lending caps and encouraged banks to step up lending, neither the government nor banks are willing to accept additional risk given concerns about excess production capacity among many borrowers and a deteriorating outlook for demand for manufacturers' products. As a result, China's recent interest rate cuts are unlikely to spur lending, according to Newman. He also expressed concern that the government had cut lending rates more than deposit rates, thus squeezing banks' intermediation margins at a time when non-performing assets were expected to rise and put downward pressure on profitability.

Continuing Risks for Banks

¶8. (SBU) Each of the three bankers expects a rise in non-performing loan ratios as growth slows, particularly among private SME exporters. The biggest banks will also face lower fee-based earnings as local investors trade fewer mutual funds and other equity-related financial products due to the weak stock market. Less systemic threats include property-related lending schemes that some property developers and wealth management firms used to circumvent lending quotas. In one scheme, property developers would threaten their banks with default unless the bank agreed to extend

favorable mortgage terms to home buyers. In other cases, funds of banks' wealth management clients were channeled to trust companies who then made an "equity investment" in property developers with "a guaranteed return" (thus allowing banks to circumvent loan limits). Even though these assets and liabilities are off balance sheet, reputational risks could force banks to make their best customers whole in case of losses. Thus, as a result of these and other possible schemes, banks' actual exposure to the property sector was higher than senior management had thought.

Unrealized Opportunities?

¶9. (SBU) SDB's Newman suggested that the lack of exotic and sophisticated financial products insulated many of China's banks from the worst problems seen in U.S. and E.U. institutions. At the same time, the role of these products in the crisis may make it more difficult to convince China's regulators that continued innovation in financial products like derivatives is in the country's best interests.

¶10. (SBU) One banker told us that the lack of merger and acquisition activity between medium and small Chinese banks is an unrealized opportunity. He said several of the strongest city banks would be excellent takeover candidates for strong regional banks like SDB and GDB. He theorized that the absence of these transactions might indicate a prevailing aversion to such deals by local officials, especially when viewed in comparison to the recent pace of PRC banks taking over competitors in Hong Kong and Macau.

Comment: Hard Times, But Not Impossible

¶11. (SBU) With high exposure to the export sector, bankers in south China are generally more concerned than their colleagues in other regions about the short and medium-term outlook. This exposure primarily takes the form of loans to small and medium-sized private exporters, which are less likely to gain direct government support than home mortgages or loans to real estate developers. However, each contact expressed optimism that his institution would weather

the downturn and continue to remain profitable, albeit with greatly reduced profits. Interlocutors were cautiously optimistic that although local government officials would press banks to help struggling businesses to maintain employment and ensure social stability in isolated cases (particularly as these local governments have been forced to compensate workers of bankrupt firms for unpaid wages), regulators would not force banks to prop up unviable enterprises to a systemic extent, as during previous severe cyclical downturns. Such an approach would undermine the longstanding efforts of both senior bank management and regulators to turn China's banks into more commercially oriented enterprises.

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